Government Bond Secondary Market Liquidity: *Seven Basic Requirements*

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Will You Buy It? Can You Sell It?

- Liquid bonds can be sold easily, in large amounts and with minimal impact on the selling price.
- In extreme cases, illiquid bonds remain unsold for long periods or must be sold at a discount.

Liquid Domestic Government Bond Secondary Markets

- Establish “risk free” reference yield curves
- Allow accurate derivatives pricing
- Facilitate cost-effective risk management
- Support the development of sound corporate debt capital markets
- Support the development of sound money markets
- Create “risk free” assets to meet regulatory liquidity requirements
- Allow optimal bank liquidity management

Liquid Domestic Government Bond Secondary Markets (cont.)

- Enable governments to borrow for longer terms
- Promote the development of institutional savings sectors (e.g., pension funds, insurance companies, mutual funds)
- Lower government funding costs
- Promote overall financial stability
- Act as shock absorbers in a crisis
- Lower systemic risk
- Precede full capital account convertibility

Liquid Government Bond Secondary Markets: *Seven Basic Requirements*

1. Disciplined issuance and reissuance programs to support large benchmark issues
2. Liquid “classic” term repo markets that allow easy short selling of government bonds
3. Active, liquid government bond futures markets
4. A broad range of liquid OTC derivatives contracts and exchange-traded derivatives contracts
5. High-quality, efficient and cost-effective electronic price discovery, trading, clearing and settlement platforms
6. A broad, active domestic and foreign investor base (e.g., pension funds)
7. Market friendly regulatory, accounting and tax regimes: no withholding taxes and no transaction taxes

Bond Issuance Program

- Disciplined and transparent, so market participants can anticipate precisely and plan for new issues
- Active retiring and reissuance (taps), to encourage the development of benchmark issues
- Broad product range availability in the market, including long-dated bonds, inflation-indexed bonds, zero-coupon bonds and strips

Why Classic Term Repos Are Important

- Support primary markets
- Allow Primary Dealers to hedge
- Improve secondary market liquidity by fostering:
    - Price discovery, two-way pricing
    - Market making, trading vs. broking
    - Counterparty participation for shorting which provides:
        - Multiple trading strategies
        - Hedging tools

More Reasons Why Classic Term Repos Are Important

- Provide the prerequisite for a bond futures market
- Facilitate development of OTC derivatives markets
- Broaden funding markets (because secured)
- Link money markets, bond markets, futures markets and OTC derivatives markets

Active Government Bond Futures Markets

- Are critical to the rapid hedging of large-value transactions (e.g., for underwriters, Primary Dealers)
- Facilitate the development of OTC derivatives
- Enhance bond (cash) and OTC market liquidity
- Reduce systemic risk
- Lower credit risk

Active OTC Derivatives Markets

- Support primary markets
- Allow Primary Dealers and corporate bond underwriters to hedge
- Enhance liquidity of bond (cash) and futures markets
- Allow banks and corporates to hedge
- Sustain project finance and other long-term ventures
- Promote interest rate OTC markets, which are key to other OTC derivatives markets (e.g., FX, commodities, equities)

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High-quality, Efficient and Cost-effective Electronic Price Discovery, Trading, Clearing and Settlement Platforms

- Inefficiencies and costs reduce trading volumes
- Competition stimulates product development

Broad and Active Investor Base

- Domestic institutional savings sector:
  - Pension funds
  - Insurance companies
  - Mutual funds
  - Other institutions and corporations
- Retail investors (generally more limited)
- Foreign direct investment in domestic interbank government bond markets, repos and derivatives

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Excessive Taxes Dampen Market Activity

Examples：

- Withholding taxes (domestic and foreign)
- Transaction taxes
- Business taxes and value-added taxes
- Capital gains taxes
- Taxes on total assets or total liabilities
- Unclear taxes
- High cost of state owned monopoly service providers

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Certain Laws and Regulations Impede Market Development

- Capital and FX controls
- Excessive liquidity requirements
- Encouragement of a hold-to-maturity culture
- Weakened or unclear creditor's rights (e.g., close-out netting and cherry picking in bankruptcy)
- Restrictions on and barriers to market participation
- Unclear regulation or accounting treatment
- Slow response to requests for rulings on regulations, taxes or accounting treatment
- Changes in regulations without a suitable phase-in process

Characteristics of Classic Repo

- Title transfer
- Single contract for both legs
- Standard documentation (GMRA)
- Overnight, term and open
- General collateral (equivalent bonds) and special (specific bonds)
- Initial margin and margin calls
- Hold-in-custody, delivery or tripartite repo

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Characteristics of Classic Repo (cont.)

- Seller remains beneficial owner:
  - Risks and returns
  - Taxes
  - Manufactured coupon
  - Unfettered right of substitution
- Buyer becomes legal owner:
  - Receipt of coupons but payment of “manufactured” coupons
  - Right to re-use: sell, repo, pledge!
  - Collateral can be sold “immediately” in the event of default
  - Taxes

Pledge Repos

- No title transfer
- No re-use possible (cannot short)
- No new trading strategy
- Buyer gives up cash and liquidity
- Tax and accounting (usually unaffected)
- No support of overall market liquidity
- No positive impact on the development of the bond futures market

Why Market Participants Use Classic Repos

Sellers

- Bond portfolio finance (general collateral)
- Cheaper because secured
- Stable/reliable source of funds (because secured)
- Leverage
- Additional income/yield possible

Buyers

- Low credit risk lending
- Efficient deployment of funds (lower capital charges)
- Shorting a specific issue
- Trading strategy

Why Market Participants Use Repos in General

- Some trading strategies possible with repos/shorting:
  - Drop in value
  - Relative value trading – arbitrage:
    - Divergence or convergence
    - Spread trading
    - Slope trading
    - Carry trade

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Requirements for Term Repos

Infrastructure

- Confidential reporting of short positions to the central bank:
    - Monitor abuse with clear rules (e.g., intentional fails, squeezes)
    - Sanction for abuse
    - Monitor systemic risk
    - Aggregate for delayed public reporting of shorts
- No restrictions on naked short selling
- No pre-borrowing of bonds requirements
- A tolerance for fails (i.e., no event of default trigger for repos):
    - Convention for compensation
    - Operational errors, system failures, power failures, hectic markets, interconnectivity, chain of transactions

Requirements for Term Repos (cont.)

- Ability for central banks to issue phantom or synthetic or new bonds:
  - Alleviate or discourage squeezes
  - Anonymous
  - High cost
- Convention on general collateral
- Ability to find specials (help from interdealer brokers or CDC?)
- Accurate valuations of outstanding bonds
- Anonymous trading (especially for shorts); need brokers?

Requirements for Term Repos (cont.)

- Standard documentation (GMRA 2011)
- Master, bilateral and single agreement, includes settlement and close-out netting provisions
- Clear and suitable accounting and tax treatment
- Creditor's rights:
    - Close-out netting
    - Set off
    - Disposal of collateral
    - Finality of payment
    - Settlement netting
- Efficient, dependable, sophisticated, competitive and low cost depository:
    - Central Counter Party?

Requirements for Term Repos (cont.)

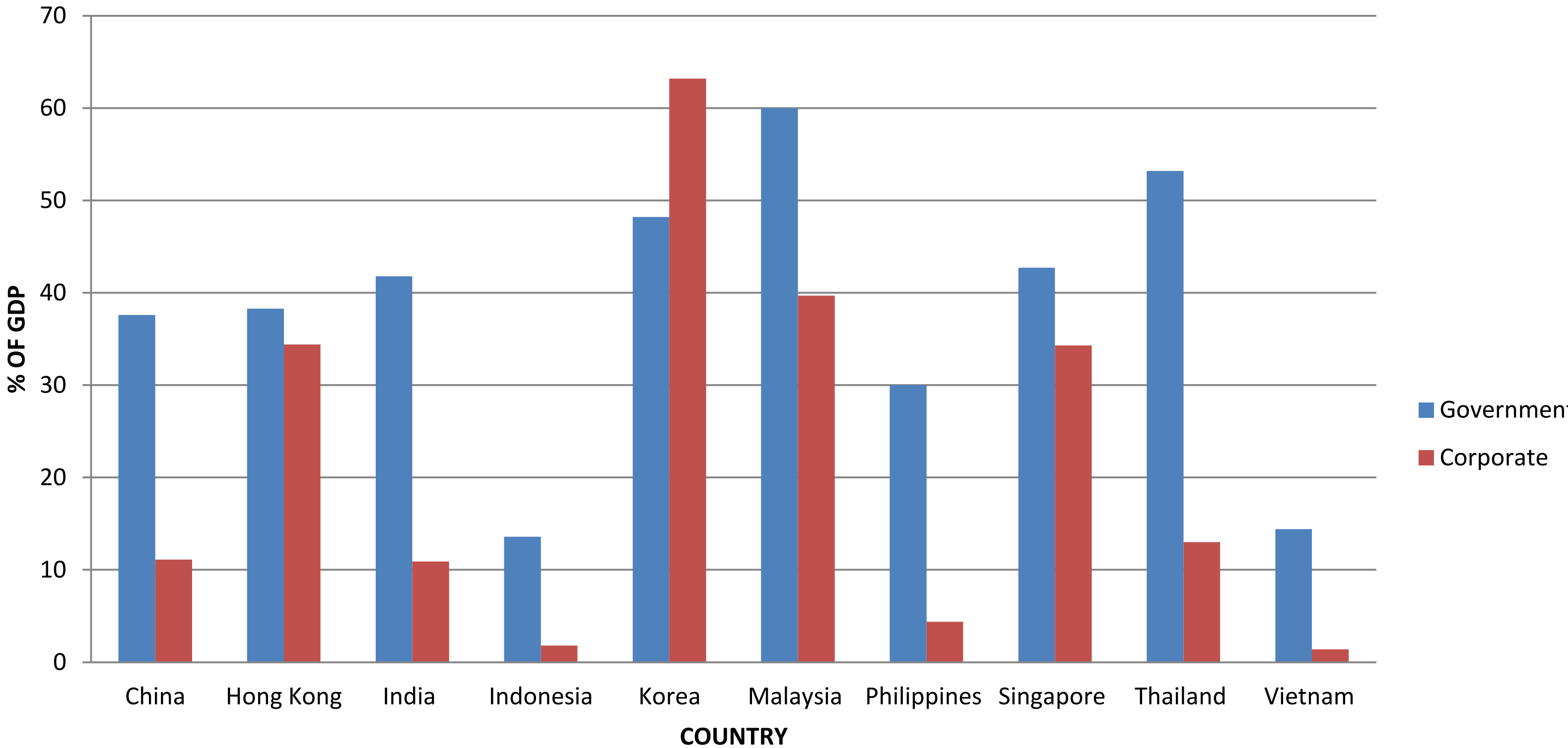
<u>Market participants must have</u>

- Collateral management capability including:
  - Netting
  - Initial margin and margin adjustments
  - General collateral and specials
- Suitable back-office and operational capabilities
- Efficient post-trade and pre-settlement confirmation
- Good links with CDC

Requirements for Term Repos (cont.)

- Suitable credit lines in place
- Good risk management systems providing:
  - High-quality credit risk assessment of borrowers and collateral
  - The possibility of daily portfolio evaluation (market risk)
  - The ability to evaluate bond liquidity
  - Quick identification of fails
  - The ability to evaluate legal risk
- A process that allows location and delivery of specific bonds
- Incentive to participate in the repo market

Size and Composition of Asia Ex-Japan LCY Bond Markets as % of GDP - Q1 2011*



***Source: ADB "Asia Capital Markets Monitor" August 2011, p.52 (http://www.asianbondsonline.adb.org/publications/adb/2011/acmm_2011.pdf?src=spotlight).**

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